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# COMPETITIVENESS BASELINE AND INSTITUTIONAL DIAGNOSTIC (CBID)

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# Competitiveness Baseline and Institutional Diagnostic (CBID)

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## Competitiveness Baseline and Institutional Diagnostic (CBID)

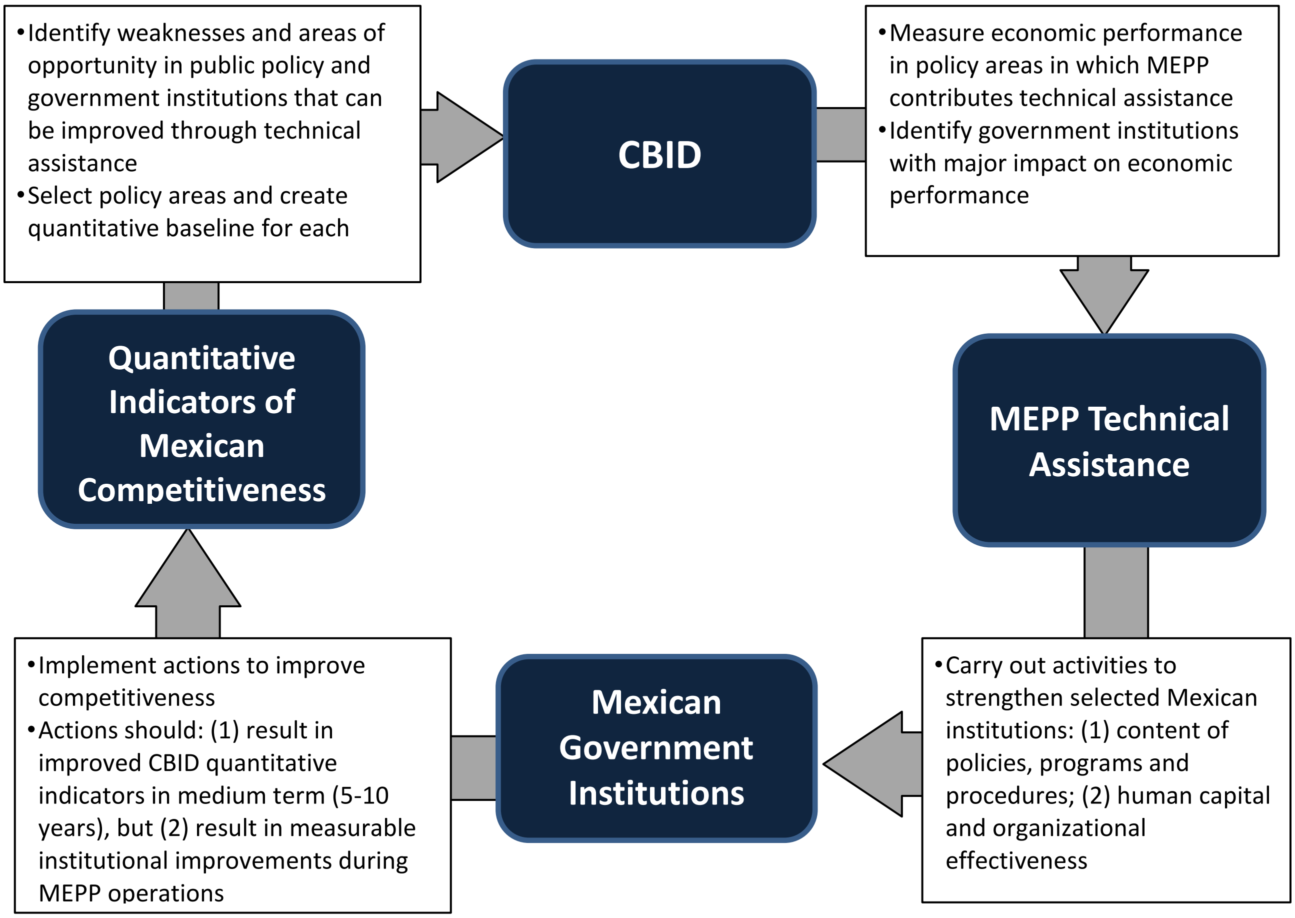
**Criteria for the Selection of Activities and Indicators in the USAID/Mexico Economic Policy Program**

Mexico's competitiveness and economic policy challenges have been the subject of extensive research, documentation and debate. International organizations and think tanks, Mexican research institutions and the Mexican government itself have produced hundreds of books, reports and data sets that describe the country's fiscal management, business climate, productivity, innovation, financial sector development, market structure and regulation, trade and investment. What emerge from these studies are two distinct tendencies in economic policy: on one hand, a foundation of macroeconomic stability and global integration; on the other hand, microeconomic obstacles and domestic institutional weaknesses that limit the potential for private sector growth.

The purpose of this document is not to surpass this impressive array of literature and data analysis. Rather, the *Competitiveness Baseline and Institutional Diagnostic* (CBID) reviews and summarizes these assessments in order to identify (1) policy areas that have significant impact on holding back the Mexican economy, and (2) key Mexican institutions, especially public sector organizations, that influence those policy areas and that could also be strengthened through foreign technical assistance such as that offered by USAID.

In particular, the CBID provides the context and justification underlying the activities and goals of the USAID/Mexico Economic Policy Program (MEPP). It therefore represents a key input for MEPP's Performance Management Plan (PMP), which includes indicators on the Program's real world impact. Figure 1 shows how the competitiveness indicators identified in the CBID relate to MEPP´s governance work, which will have a measurable impact on the operations and capacity of Mexican institutions.

*Figure 1 – CBID Flowchart*




In this regard, the CBID is highly selective. Its purpose is to identify constraints on *high-impact* private sector activity. USAID technical assistance under the Mexico Economic Policy Program focuses on four policy areas in which domestic institutions affect the resources, incentives and information available to private sector firms:

- Transparency of economic governance institutions
- Market regulation (competition)
- Access to finance by SMEs
- Commercial law (B2B, creditor-debtor transactions)

In addition to prioritizing these four policy areas, MEPP will use the CBID to focus USAID resources in several other ways. The Program will not only identify public sector institutions that affect competitiveness and entrepreneurship within each area, but more importantly specific *governance mechanisms and resources* that can be improved or strengthened through foreign technical assistance. MEPP addresses two central aspects of economic policy impact:

(1) _Content_: laws, implementing legislation (*reglamento*), regulations and rules of operation. Does policy content promote or allow rent-seeking behavior? What kinds of incentives or disincentives does it exert upon productive activity? Are formal rules consistent with legislative objectives or mandates?

(2) _Institutional capacity_: Internal procedures and practices, human capital (e.g., training and certification). Are internal procedures consistent with organization goals? Does technical and administrative staff have sufficient knowledge, skills and experience to effectively carry out the institution's mission? Are effective practices disseminated through training programs, manuals or certification processes?

Another aspect of the institutional diagnostic is a stakeholder analysis of political commitment to reform. MEPP will not commit USAID resources to governance reform, no matter how worthwhile in principle, without clear evidence of its importance to leaders within Mexico's public sector. Evidence of commitment includes: dedication of an organization's own resources and personnel to carry out USAID-supported activities, public declarations of commitment by political leaders (such as inclusion within the National Development Plan 2013 – 2018), and regular participation of high level officials.

Drawing on previous research on high-growth (or high-growth-potential) sectors and characteristics of innovative firms even within traditional sectors, the CBID will help identify key institutional obstacles that limit risk-taking, strategic investment, exploitation of market expansion opportunities, and other aspects of entrepreneurship.[1]

The most important output of the CBID is the assessment of key institutional challenges that MEPP will address through technical assistance. After three years, this assessment will be used retrospectively to evaluate the effectiveness of MEPP resources to initiate or implement governance improvements that foster private sector competitiveness.

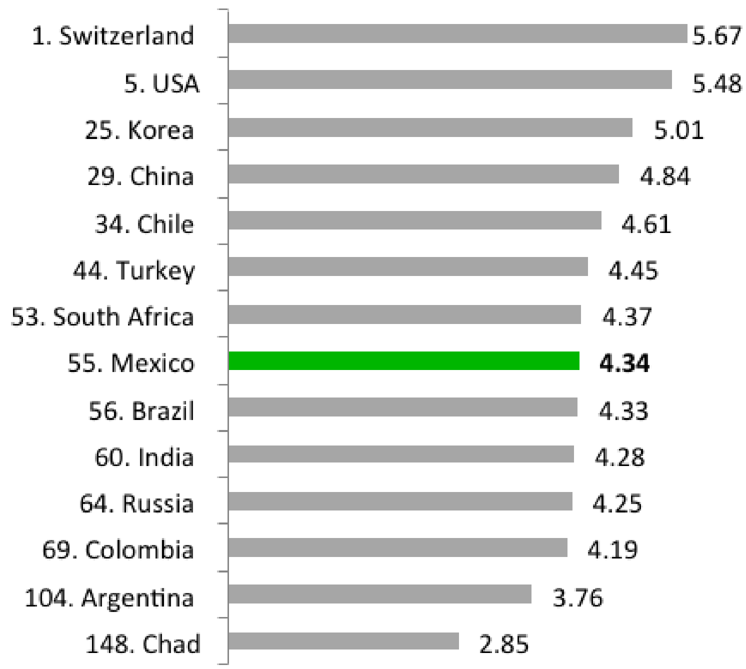
## I. The state of competitiveness in Mexico and its gaps

Mexico has demonstrated some improvement in overall economic competitiveness, as reflected by the most widely used global indicators. In the World Economic Forum (WEF) Global Competitiveness Index (GCI) for 2013-2014, Mexico ranks 55th among 148 countries, eleven positions above its ranking in the 2010-2011 edition. In the 2013 World Bank Doing Business Report, Mexico ranks 48th among 185 countries, a five position improvement from the previous year and a seven position improvement from 2008.

[1] These findings will be a relevant input for the upcoming MEPP document: *Institutional Obstacles to High Impact Entrepreneurship.*

While Mexico has risen in the rankings over time, the improvement has been modest and sporadic.  For example, notwithstanding Mexico's gradual rise within the GCI, its 2013 ranking of 55 is actually two positions behind that of the previous year. More importantly, Mexico continues to lag behind some of its most relevant competitors. Within the GCI it trails key emerging markets with similar levels of development, as well as advanced industrialized countries (see Figure 2).

*Figure 2 – GCI 2013-2014 Score and Rank among selected countries*




Source: World Economic Forum, GCI 2013-2014.

Given that Mexico is an exemplar of macroeconomic discipline and global economic liberalization, what explains its inability to achieve competitiveness levels needed for sustained high growth?

Mexico's capacity to further enhance competitiveness has been held back by persistent structural challenges. These include: weak public institutions and the resulting distrust of government agencies, promotional programs that do not provide incentives to increase productivity, and the persistence of monopolies and anti-competitive practices. Furthermore, Mexico's innovative potential is hampered by the private sector's limited use of Information and Communication Technologies (ICT). Mexico's competitiveness challenges represent areas of opportunity for policy and programmatic reform. The next section explores the four policy areas outlined above to provide insight into Mexico's status quo and the needed institutional capacity-building to change it.

## A1. Transparency of Economic Governance Institutions

Transparency and accountability play a key role within government institutions in any democratic country. Transparency in governments' budgets, decision making criteria and outcomes are critical for two reasons: informing the citizens of what, how and why decisions within public institutions are being undertaken and providing information so citizens can make better decisions. Additionally, transparency tends to reduce rent-seeking behavior, since it points out loopholes that might be exploited by certain interests groups.

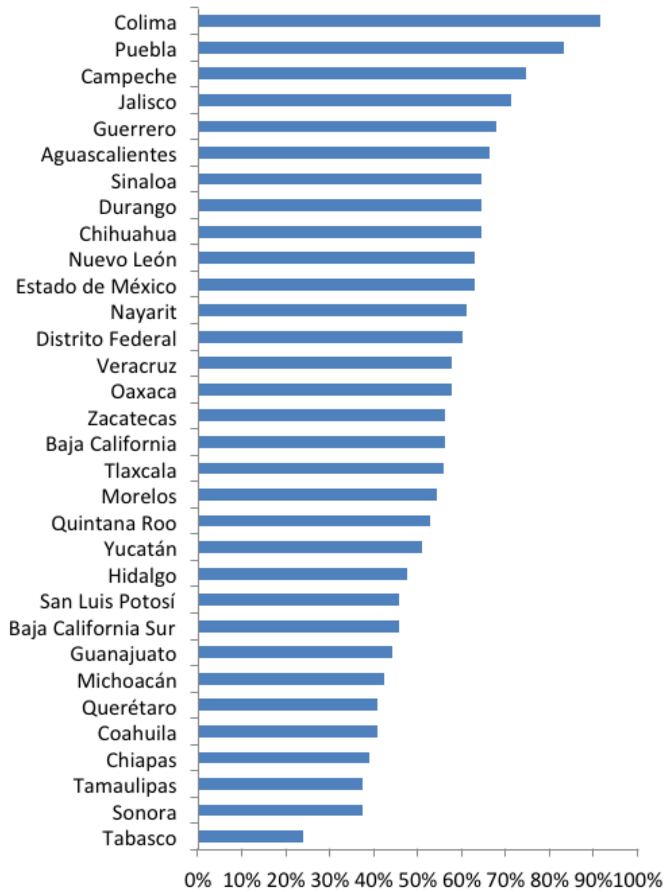
Mexican transparency has improved in the past years. Notwithstanding important efforts to create institutions and tools that increase citizen access to national and state government information, challenges remain. Budget transparency and open government improvements have enhanced participation and empowered citizens at the national level. In terms of public expenditure transparency, Mexico showed a significant improvement in the Open Budget Index (OBI)[2] moving up 15 positions from 2010 to place 23 amongst 100 countries in 2012 (International Budget Partnership, 2012).

However, state government still shows significant weaknesses. For instance, the Mexico Competitiveness Institute (IMCO) Budget Index shows significant variation in transparency among the states, and indicates that most states do not disaggregate key public expenditure information (IMCO, 2012). The Index measures 59 criteria that look at if and how information is available, classified and broken down into categories; in which cases; and how funding is allocated.[3] Figure 3 shows the example of Tabasco, the state least transparent in terms of budget, meeting only 14 of the 59 criteria evaluated by IMCO, with important challenges in topics such as budget allocation and public debt disclosure. In contrast, Colima is the most transparent state, meeting 54 criteria.

[2] The index is constructed with an Open Budget Survey that measures budget transparency, accountability and participation at the national level. The Survey does not reflect opinion but measures observable facts related to these areas. It is published twice a year by the International Budget Partnership and is completed by independent researchers in the countries assessed.

[3] The evaluation's complete cirteria catalog is available here: http://imco.org.mx/finanzaspublicas/metodologia/

*Figure 3 – State Budget Transparency Index 2012*

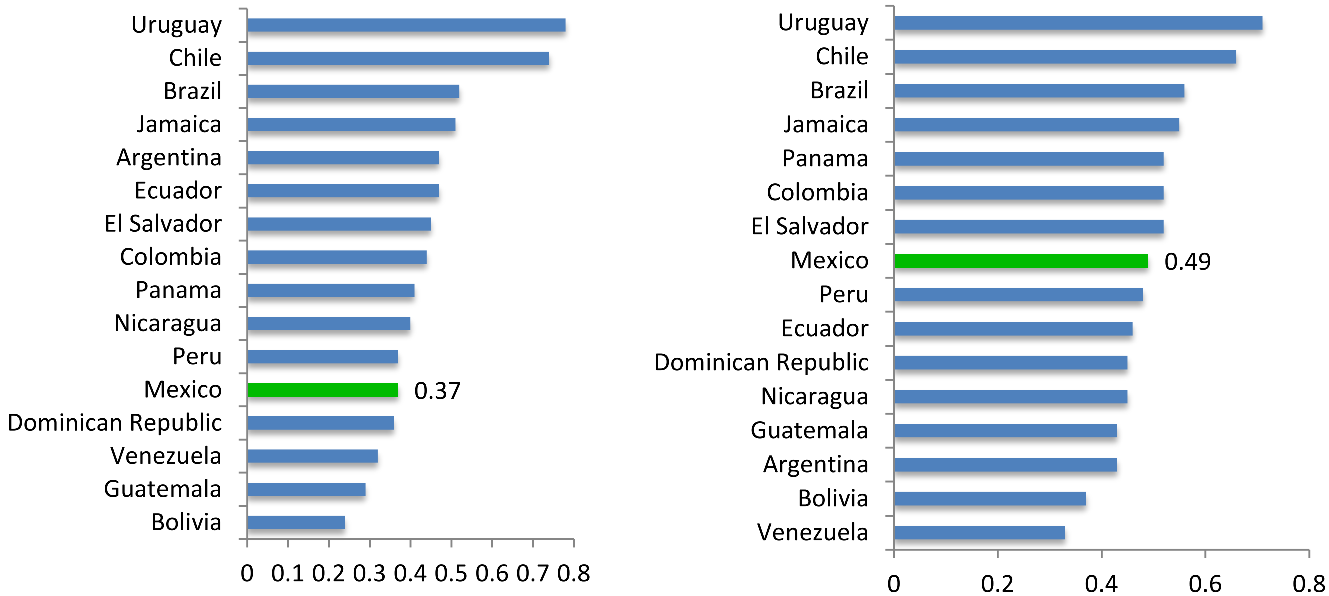



Source: IMCO (2012a).

More broadly, the transparency of Mexican economic governance institutions is poor. Transparency International's 2013 Global Corruption Barometer ranked Mexico in 100th place among 183 countries; 83% of respondents believed the legislature was corrupt or extremely corrupt, while 80% and 87% felt the same about the judiciary and public sector officials, respectively.

As Figure 4 shows, the Rule of Law Index 2012-2013 from the World Justice Project indicates that Mexico ranks 8th out of sixteen for regulatory enforcement and 11th for absence of corruption in the Latin America & Caribbean region. These results show citizens' lack of trust regarding the design and implementation of government procedures and regulations.

*Figure 4 – Regulatory Enforcement and Absence of Corruption in Latin America and the Caribbean*




Source: Rule of Law Index 2012-2013.
* 1 signifies the highest score and 0 signifies the lowest score.

The 2013-2014 GCI weights country performance in twelve pillars[4] that reveal important differences and weaknesses within Mexican institutions. For instance, Mexico ranks 86th in terms of favoritism in decisions of government, and 105th in terms of diversion of public funds, out of a sample of 148 countries.[5] The GCI also reveals challenges related to the effectiveness and impartiality of government decision-making and fund allocation mechanisms, as well as promotion of their use among citizens. Institutional weakness in this area enables and encourages rent-seeking behavior.

Large-scale cash transfer programs managed at the ministerial level are characterized by lack of transparency. In the specific case of the Fondo PyME –Mexico's largest business promotion fund–Mexico's principal auditing institution (Auditoria Superior de la Federación, or ASF) found that the Ministry of Economy did not comply with applicable regulatory provisions in 2010. For example, parameters to evaluate goal achievement were not established and the indicators that measured the program's performance were not robust. There was no follow-up to actions of intermediate bodies or beneficiaries, making it impossible to track the progress and

[4] The Index is composed of twelve pillars that measure different aspects of competitiveness including institutions, infrastructure, macroeconomic environment, health and primary education, high education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation. Further reference will be made to the Index focusing on specific measures within pillars relevant to this study.
5 Mexico declined significantly in these two indicators from previous (2012-2013) Global Competitiveness ranking, moving down 13 and 17 positions respectively.

achievements of projects. Finally, beneficiaries did not submit corroborating documentation for transactions accounting for almost three quarters of the Fund's total (ASF, 2010).

In order to reduce barriers to transparency and support Mexican-led efforts to increase transparency in public sector policies and processes, MEPP will pursue objectives such as more transparent and accountable government procurement, program operations and rules, and evaluation of specific government programs.

## A2. Market regulation (Competition)

For the purpose of simplicity, this competitiveness baseline addresses two distinct but related aspects of market regulation: (1) market efficiency and competition; and (2) time and cost burden of complying with government regulation. On one hand, market efficiency is achieved by curbing monopolies and private sector actions that raise prices or limit the entry of competitors. Poor performance in market efficiency is typically the result of weak or ineffective government regulation. On the other hand, excessive cost of regulatory compliance is the result of government doing too much. Burdensome regulations not only require firms to dedicate time and money to deal with red tape, but also create barriers to entry (and therefore weaken competition), especially for SMEs with limited resources to comply with arbitrary or unnecessary administrative requirements.

### Market Efficiency

Robust competition, low barriers to entry and the inability of rent-seeking actors to set prices or limit output characterize functioning markets. However, competition does not happen automatically, especially in sectors with natural barriers to entry (e.g., those requiring large lump sum investments, specialized technologies or capacities, or access to complex information). The government has a major regulatory role in monitoring and sanctioning anti-competitive behavior, as well as encouraging the creation of new businesses.

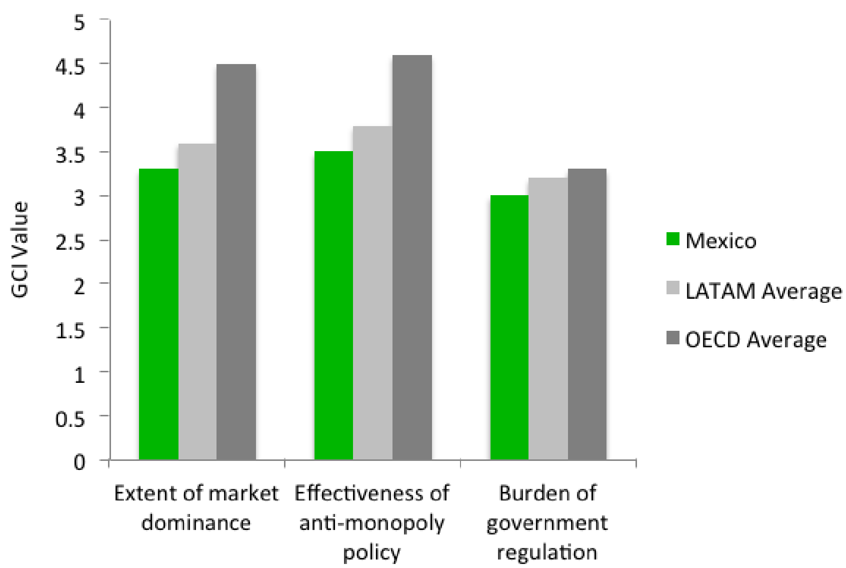
In this context, public policies that regulate markets have a major impact on competitiveness and economic growth, since they directly affect the supply, demand, price and quality of goods and services. In the case of Mexico, federal, state and local governments influence the rules and regulations under which enterprises operate; but the content of regulation is only as effective as its implementation. Applying market regulations transparently, objectively and consistently is essential for creating a competitive business environment.

Highly competitive markets generate great benefits for consumers, including other businesses that buy goods and services as inputs. The existence of more competitors creates more opportunities and increases incentives to increase productivity and pursue innovation. From the consumer perspective, highly competitive markets result in more, better and cheaper goods and services. In the same vein, weak markets increase costs for consumers and firms, limiting the creation of new businesses and the interest of private investors to risk capital in sectors where rent-seeking interests are more powerful than good ideas or sound management.

Although Mexican markets have become highly competitive in certain sectors, others continue to be characterized by dominant firms, resulting in much higher prices and lower quality than found in the same sectors in other countries. Monopolies and oligopolies prevail in telecommunications, financial services and energy. They also exist in many smaller sectors at the regional level. In addition, rent-seeking and bid-rigging are common in the huge markets for public sector procurement. In each case, absent or weak regulation limits Mexico's competitive potential.

According to the OECD, 30% of household expenditures in Mexico take place in markets in which competition is weak, leading to a 40% average overprice in affected goods and services (OECD, 2012). High price levels have a significant impact on small businesses that face high fixed costs, which inhibit market entrance. This situation is reflected in the GCI, in which Mexico ranks 107th out of 148 countries in market dominance, and 114th in effectiveness of anti-monopoly policy. Figure 5 shows where Mexico stands compared to Latin America and OECD subgroups.[6]

*Figure 5 – Comparison of GCI indicators for Mexico, Latin America and OECD countries*

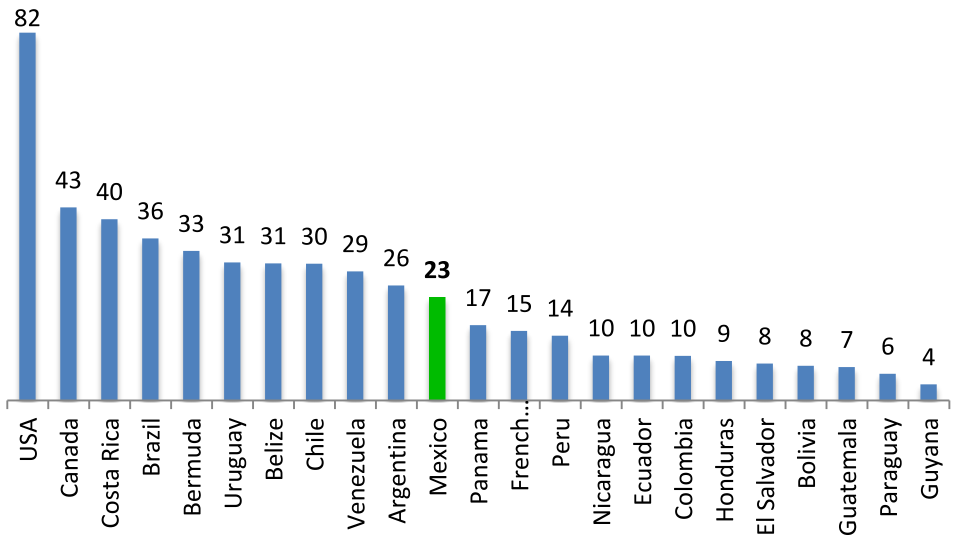



Source: World Economic Forum. Global Competitiveness Index, 2012-2013.

[6] All three variables are measured on a scale from 1 to 7. For market dominance 1 indicates domination by a few business groups while 7 indicates market presence of many firms. For effectiveness of anti-monopoly policy, 1 indicates absence of competition promotion while 7 indicates highly effective, promotes competition. For burden of government regulation 1 corresponds to high burden while 7 indicates absence of burden. Averages for Latin America and OECD do not include Mexico.

In the telecommunications sector, lack of competition generates higher prices for consumers and businesses, and slows the supply of new services. Weakness in policy and sector regulation results in high market concentration, low penetration of telecommunications services and higher costs (OECD, 2012). Figure 6 shows that mobile broadband penetration[7] in Mexico is only 23%, far lower than other Latin American countries with similar levels of development.

*Figure 6 – Mobile Broadband Market Penetration for the Americas Q1-2012*




Source: Wireless Intelligence, 2013.

Competition in Mexico is also weakened by public sector companies whose inefficiencies generate significant costs for consumers and other businesses. For example, electricity supply in Mexico is monopolized by the state-owned Comisión Federal de Electricidad, which charges higher prices for customers and creates barriers to entrepreneurship. According to the World Bank's Doing Business 2013 report, business costs for installation of electricity represent 382.8% of the country's annual per capita income,[8] a figure that is almost four times higher than the average for OECD countries (around 108% of per capita income).

## Government Regulation

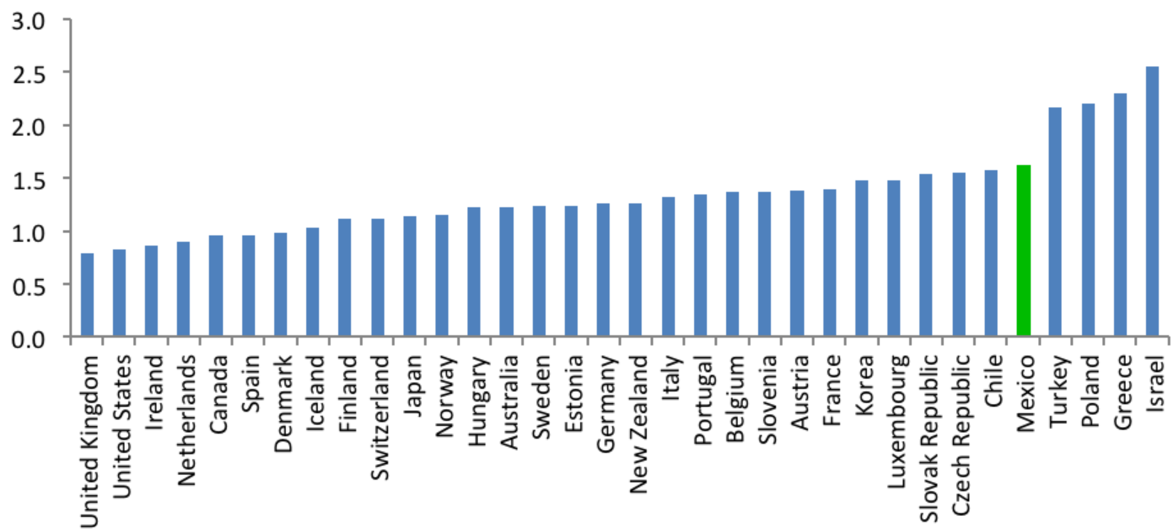
Another obstacle to market competition and entrepreneurship is the burden of government regulation. As mentioned above, too much government regulation can disadvantage SMEs as they struggle to comply with excessive and burdensome regulations. The GCI index ranks Mexico 111th for burden of government regulation with a value of 3, falling behind the rest of LATAM and the OECD averages (see Figure 5).

[7] Mobile broadband is measured as the number of mobile broadband connections at the end of the period expressed as a percentage of the total market. The widespread use of mobile devices and their ubiquity, even in the lower income sectors of the population, makes this platform the preferred type for Internet connection in the region.

[8] The cost is recorded as a percentage of the economy's annual income per capita.

The OECD 2008 Product Market Regulation Index, which measures the restrictiveness of regulatory policy on a scale from 0 to 6, (higher meaning more burdensome) shows that Mexico is among the most restrictive countries in the group, performing only better than Turkey, Poland, Greece and Israel (see Figure 7). The indicators that comprise the Index measure the extent to which policies promote or inhibit competition due to state control, barriers to entrepreneurship, and barriers to trade and investment.

*Figure 7 – OECD Product Market Regulation Index[9] 2008*




Note: The index is calculated on a scale from 0 to 6, from less to more restrictive.
Source: OECD, 2011. Product Market Regulation Database.

According to a study by IMCO (2013) on regulation and Official Mexican Standards (NOM, by its acronym in Spanish), the misuse of NOMs can have serious repercussions to markets by creating entry barriers to new competitors and favoring monopolistic practices. That is, rather than serving to promote positive societal goals such as consumer safety or environmental protection, standards can serve primarily to entrench the position of rent-seeking interests. As a result of these practices, consumers must pay higher prices for the goods or services improperly regulated.

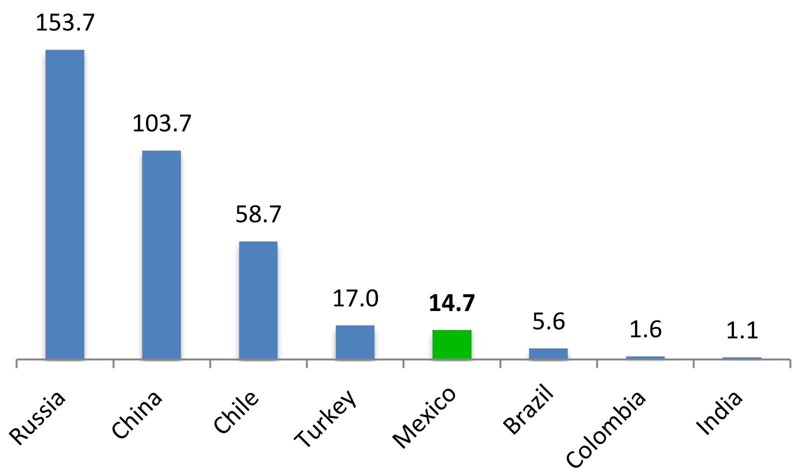
Corruption in regulatory institutions inhibits competitiveness and weakens policies that aim to promote competition. Aside from being a transparency issue, corruption can distort market performance by increasing transaction costs. On an aggregate basis, Mexican enterprises spend approximately 6.1% of their income on administrative-bureaucratic corruption at the federal

[9] This PMR Index integrates the indicators of regulation in non-manufacturing sectors (NMR) and the FDI regulatory restrictiveness index.

level (Centro de Estudios Económicos del Sector Privado, CEESP for its Spanish Acronym, 2005). The existence of unofficial payments can influence the content of new laws, policies and regulations and can represent serious obstacles to entrepreneurship. Minimizing the number of procedures required for business operations, or shifting to transparent online procedures, can help minimize corruption. Market regulation can be strengthened to foster competition by limiting bureaucracy and rent-seeking behavior -- thus the importance of designing norms and standards with transparent and objective criteria.

For sophisticated markets, with equally sophisticated players, norms and regulations can promote or hinder growth. For instance, intellectual property rights can and should promote research and development by private actors. In today's economy, where competitiveness is based less on traditional factors of production and more on knowledge and innovation, intellectual property has become increasingly important (OECD, 2008). Strengthening regulatory institutions is essential for the protection of intellectual property rights that provide incentives for experimentation and innovation.

*Figure 8 – Direct approved patent grants per million inhabitants*




Source: WIPO, 2011.

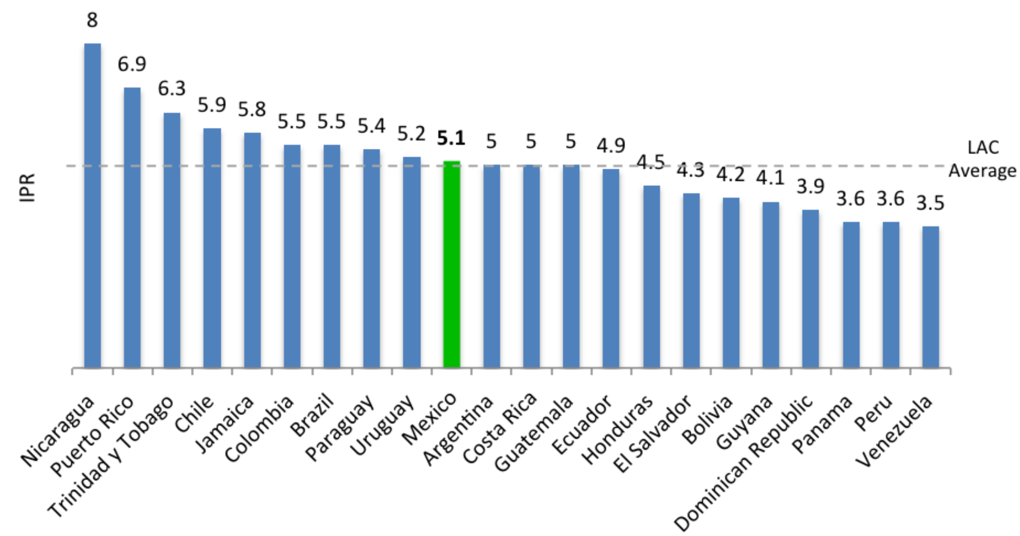
According to the World Intellectual Property Organization (WIPO), during 2011 firms and individuals in Mexico filed 16,066 patent applications. However, only 6.6% were from Mexican nationals. Even though the number of patents has been growing, the number of approved direct patent grants[10] is significantly lower than the BRICs[11] and other countries at a similar level of development (see Figure 8). Between 2000 and 2011 there was an increase of 60% in the number of applications by Mexican residents and the participation of resident applications

[10] Direct patent grants do not include PCT (Patent Cooperation Treaty) international applications.
[11] BRIC refers to the countries of **B**razil, **R**ussia, **I**ndia and **C**hina, which are all deemed to be rapidly growing emerging markets.

with respect to Latin America and the Caribbean (LAC) has almost doubled. However, the total number remains low relative to Mexico's large economy and population.

According to the International Property Rights Index (IPRI)[12] of 2012, Mexico does well in overall performance, ranking 40th of 130 countries and 4th out of 22 in the LAC region.[13] However, a careful look at the components of the Index reveals that in terms of Intellectual Property Rights (IPR),[14] which measures the protection of intellectual property, Mexico falls to 65th globally and 22nd for LAC with a 5.1 score (see Figure 9). The GCI provides further evidence through its indicator of intellectual property protection where Mexico ranks 77th.

*Figure 9 – Intellectual Property Rights in Latin America and the Caribbean*




Note: The IPRI ranges from 0 to 10, with 10 representing the strongest level of property rights protection and 0 reflecting the non-existence of secure property rights in a country.
Source: IPRI, 2012.

SMEs in Mexico have relatively poor access to information, knowledge and funding necessary to invest in innovation (OECD, 2007). These limitations inhibit patent registration. Some of the reasons that explain Mexico's low patent registration include the lack of custom to use the industrial property system and lack of resources to develop innovative products (Innovación UNAM, 2013). On the other hand, institutional obstacles include complex and time-consuming

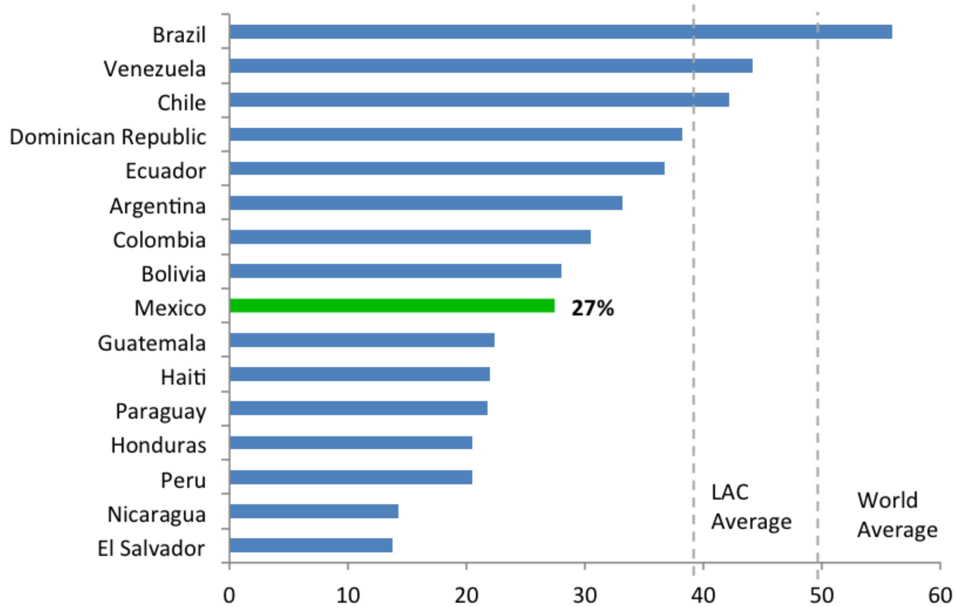
[12] The IPRI serves as a barometer of the security of property rights across the world and is compiled by three core components: 1) Legal and Political Environment; 2) Physical Property Rights; and, Intellectual Property Rights.
[13] The IPRI ranks from 0 to 10, with 10 representing the strongest level of property rights protection and 0 reflecting the non-existence of secure property rights in a country.
[14] The IPR component evaluates the protection of intellectual property. In addition to an opinion-based measure of the protection of IP, it assesses protection of two major forms of intellectual property rights (patents and copyrights) from de jure and de facto perspectives, respectively.

paperwork and lack of information about existing patents. According to a report by Baker & McKenzie (2012), in Mexico it takes approximately four years from filing to granting a patent and 2 to 6 office actions are required.

### A3. Access to finance by SMEs

Access to affordable financial services is linked to poverty reduction, greater income equality, and increased economic growth (Demirguc-Kunt & Klapper, 2012). The Financial Inclusion survey conducted in 2011 by the World Bank (Global Findex) shows that 50% of the world's adults have an account at a formal financial institution (see Figure 10) and 22% held some form of savings in those institutions. In Mexico these percentages are 27.4% and 6.7% respectively, below the levels observed in the LAC region (39% and 10% respectively).

*Figure 10 – Adults with an account at a formal financial institution (% age 15+)*

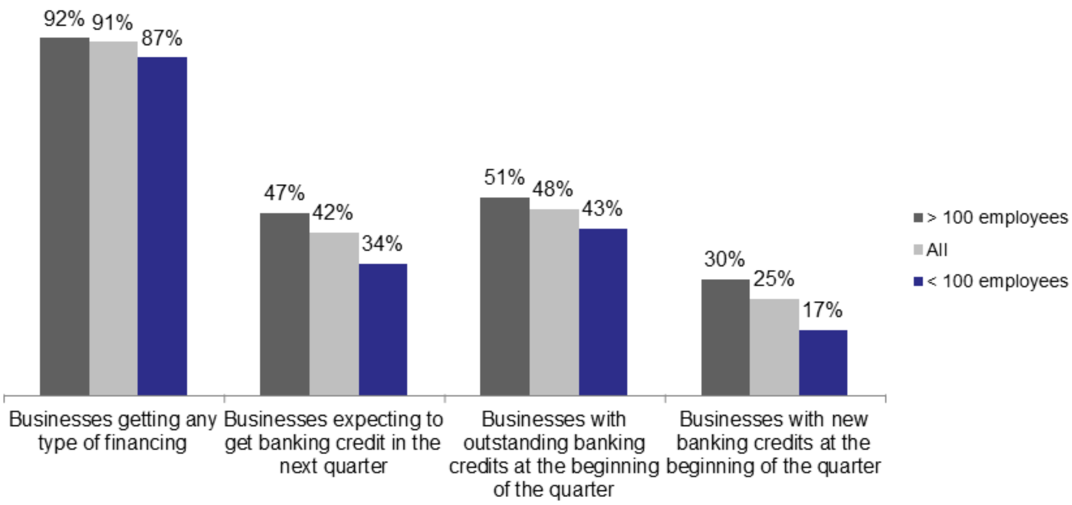



Source: Demirguc-Kunt & Klapper, 2012.

Businesses have two basic options for financing: credit (loans) and equity (private investment to gain a stake in the company).

Credit is mainly divided into non-banking (suppliers, NGOs, friends, among others) and banking credit. According to the latest Credit Market Survey, performed quarterly by Mexico´s Central Bank to a representative sample of local businesses, 90.5% of the surveyed mentioned that they had received financing through any mechanism. However, only 48% of the total had subscribed loans with banking institutions. This means that about 42% of total businesses are getting credit through non-banking mechanisms. This gap is higher among those companies with less than 100 employees. As Figure 11 shows, there is a consistent sub-use of banking credit in companies with less than 100 employees.

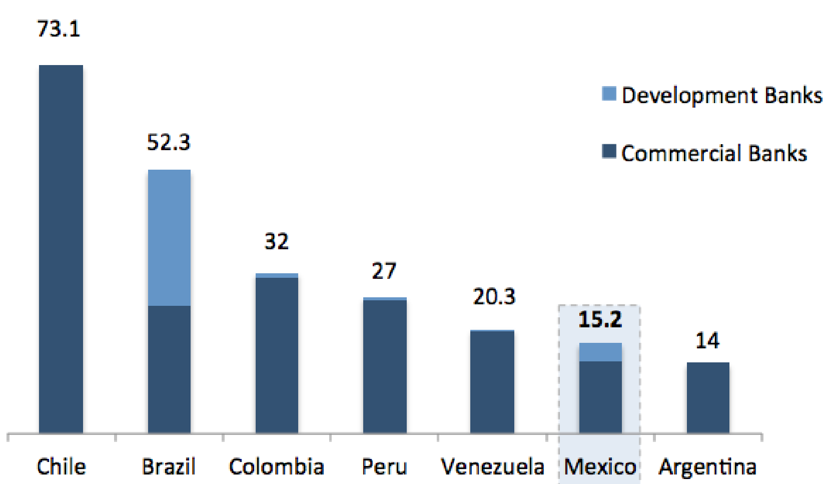
*Figure 11 – Type of financing mechanisms by business size in Mexico (June 2013)*




Source: Banco de México surveys, 2013.

In addition, a common indicator to measure the effectiveness of a banking system in promoting economic activity is total domestic bank credit to the private sector as a percentage of GDP. As Figure 12 shows, Mexico's level of banking credit to the private sector is significantly lower than that of Chile and, Brazil, Colombia and Peru (BBVA Research, 2012). Even Bolivia, with just a fraction of Mexico's per capita GDP, ranks higher.

*Figure 12 - Total domestic Bank credit to the Private Sector in selected Latin American countries (as % of GDP, 2011)*



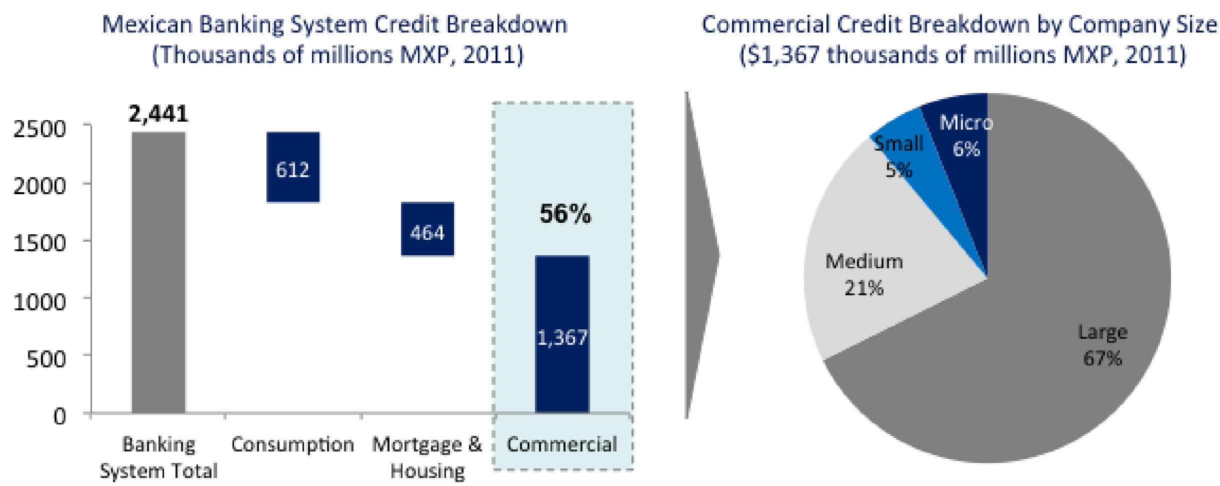

Source: BBVA Research, 2012.

Moreover, breaking down the Mexican banking system by loan type, the data shows that around 56% of the total loan volume is directed to businesses or productive activities as shown in Figure 13. However, a large proportion of those loans is directed to large companies, leaving only about 33% directed to SMEs. Factoring out medium size companies, micro and small businesses obtain only 11% of credit focused on commercial activities. Considering that micro, small and medium size companies make up over 99% of all economic units and more than half of Mexico´s GDP, the size of the credit gap represents an important constraint of growth.

It is important to emphasize that banking system instability is not a cause of the problem. Mexico´s banking system is now among the soundest in the developing world, ranking 30th in the Global Competitiveness Index out of 148 countries. Nevertheless, most micro and small businesses still lack access to credit. In addition to the relatively small proportion of credit that goes to SMEs, it is important to note that very little of that small amount – around 20% – focuses on investment activities. The remaining 80 % is used as working capital (Banco de México, BBVA, Abt Associates analysis). Loans for investment tend to be larger and have longer terms than working capital. They are also essential for firms seeking to expand production, move into new markets, carry out research or increase value-added.

Both regulatory and promotional public policies must be addressed to increase access bank financing for SMEs.

*Figure 13 – Mexican Banking System Credit Breakdown*

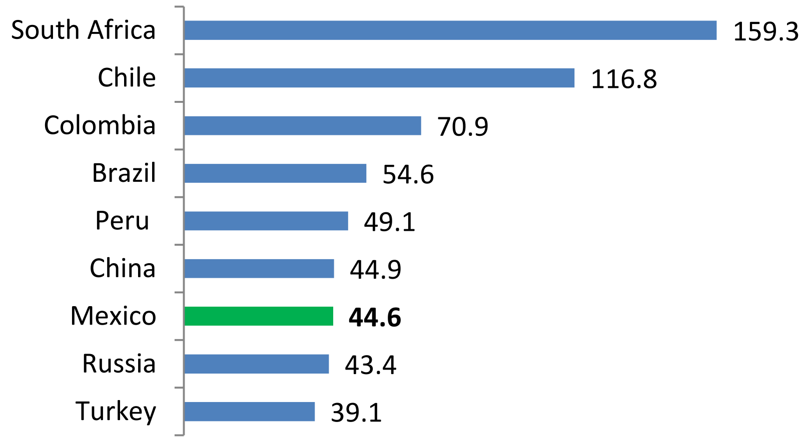



Source: BBVA Research, 2012, CNBV, Abt Associates analysis.

The second form of access to finance is through equity. Companies may issue stocks privately to investors, or they may list publicly on a stock exchange, where shares can be bought and sold on the open market. In Mexico, the latter option is viable only for firms with considerable size or profit potential. Very few Mexican firms are publicly held. A common indicator of the size and scope of the stock market in a given economy is the ratio of stock market capitalization to

GDP. In Mexico the ratio was around 45% in 2012, less than Chile, Colombia, Brazil or Peru, among others (Figure 14).

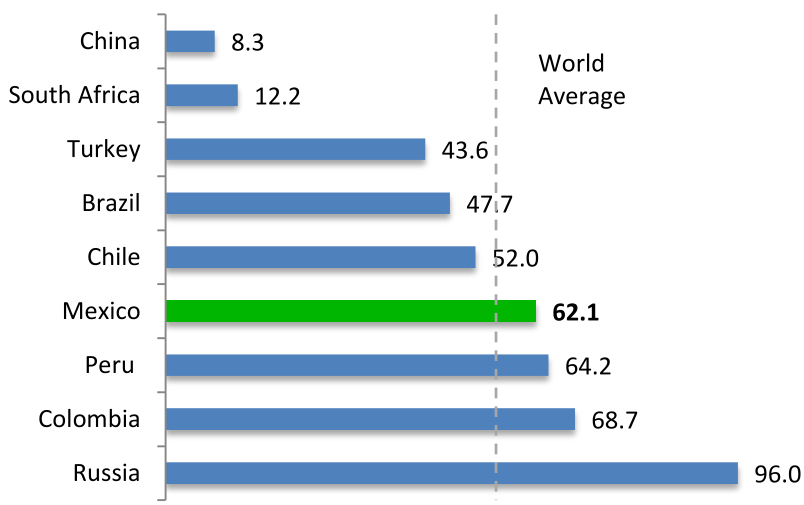
*Figure 14 – Market Capitalization of listed companies (as a % of GDP - Selected countries, 2012)*




Source: World Bank databank, 2012.

Furthermore, Mexico's stock market is highly concentrated. In 2011, the top ten listed companies represented about 62% of the Mexican stock market total capitalization, a percentage much higher than Chile's (52%) and Brazil's (48%) (WFE, 2011) The following graphic, Figure 15, compares the stock market concentration for selected countries and shows Mexico above the world average for 2011.

*Figure 15 – Value added of top ten traded companies (% of total - Selected countries, 2011)*

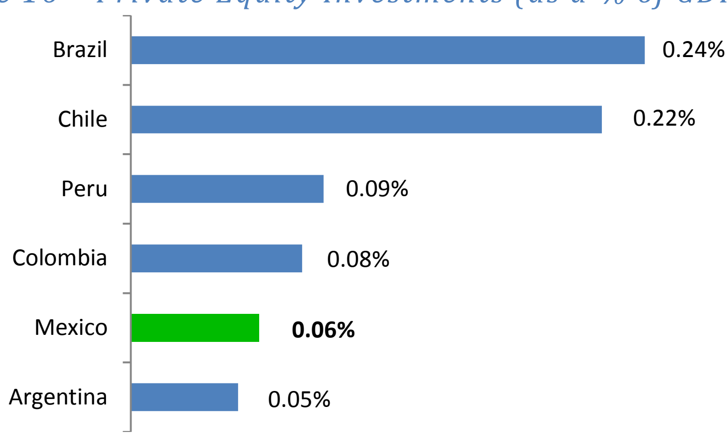



Source: The World Federation of Exchanges, 2011.

Equity markets represent an important opportunity, especially for highly innovative businesses and start ups, to share risks (and potential profits) with a diverse set of investors. There has been significant improvement in Mexico´s private equity and venture capital ecosystem in the past few years. For instance, the number of private equity funds grew from 19 in 2006 to 45 by 2012. While there were only two Mexican venture capital funds in 2006 there were more than ten by 2012. These trends demonstrate the growth of the market and the improvement of competition within it.

While financing through private equity in Mexico has grown in recent years, investment in SMEs remains low compared to other developing and Latin American countries. Mexico is moderately ranked in 'venture capital availability', and 'financing through local equity markets' -- 76th and 65th respectively in the GCI 2013-2014. However, the data suggest that there is significant room for improvement (Figure 16). Relative to the size of its economy, Mexico´s private equity investments are three times smaller than those in Brazil and Chile, and are also slightly smaller than those in Peru and Colombia.

*Figure 16 – Private Equity Investments (as a % of GDP, 2011)*




Source: LAVCA and CEPAL, 2011.

## A4. Commercial Law

Economists agree on the importance of free and robust markets. However, markets operate under laws and under institutions that must enforce those laws. The size and scope of business transactions depend in large measure on a transparent, objective, effective and efficient legal system. In this regard, commercial law has a tremendous impact on decisions made by businesses and the outcomes they experience. A robust commercial law system is the foundation of a robust market: It provides certainty, predictability and fairness to buyers and sellers, debtors and lenders, who carry out business transactions. The absence of a reliable commercial law system not only harms firms and businesses that have legitimate claims in disputes. Perhaps more importantly, it reduces the number of economic transactions businesses are willing to carry out in the first place, therefore reducing the potential for economic growth.

While Mexico improved its 2013 ranking in the Doing Business survey from 53rd to 48th out of 185 economies, there is significant room for improvement, especially at a state and municipal level (Doing Business, 2013). Entrepreneurs across Mexico face different regulations and local practices depending on the state and city where they do business. There is substantial variation of administrative rules at the state level, and considerable work remains to be done to reduce compliance costs (OECD, 2013).

The survey indicates that Mexico does relatively well in terms of the time required for Contract Enforcement and Resolving Insolvency. The World Bank reports on these two indicators annually. They can be used as proxies for a functioning commercial legal system. In terms of contract enforcement, at the national level Mexico is ranked 76th out of 185 countries, taking less time in days when compared to Latin America and the rest of the OECD (figure 17). Additionally, the number of years it takes to resolve a case when a company goes into insolvency is far less than in other Latin American countries and BRIC countries (Figure 18).

*Figure 17 – Enforcing Contracts (Number of days)*

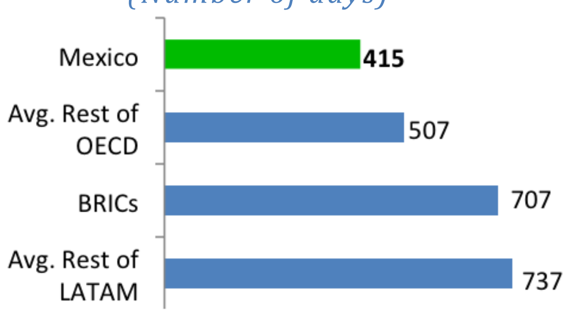
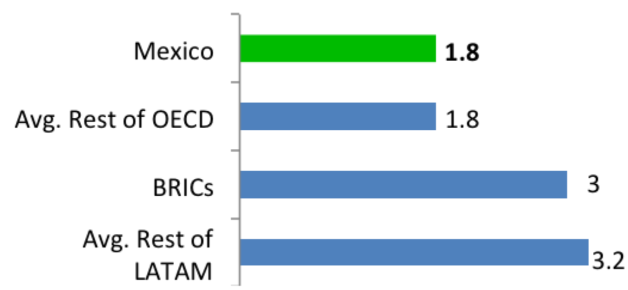



*Figure 18 – Resolving Insolvency (Number of years)*




Source: Doing Business 2013, Abt Associates analysis.

Challenges remain. For example, the cost of enforcing a contract in Mexico is high, representing 31% of the claim on average, 10% more than the average of the rest of the OECD and 11% more than the average of the BRIC countries (Figure 19). Similarly, the cost of insolvency proceedings is around 18% of the asset value, while the average for the rest of the OECD is 9.3 and 13% in the BRICs (Figure 20).

*Figure 19 – Enforcing contracts (cost as % of the claim)*

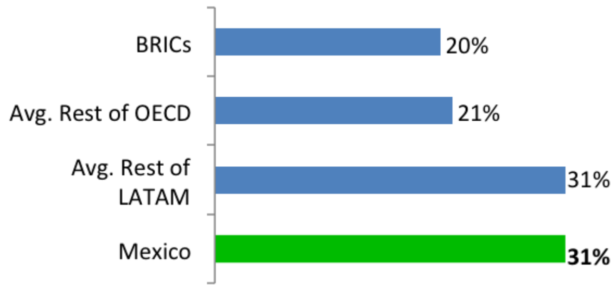
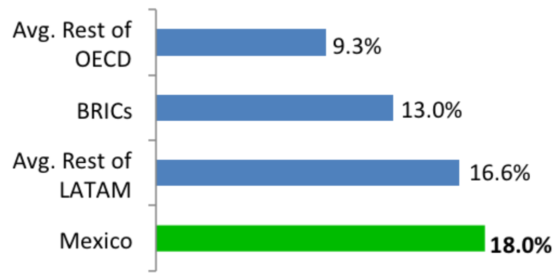


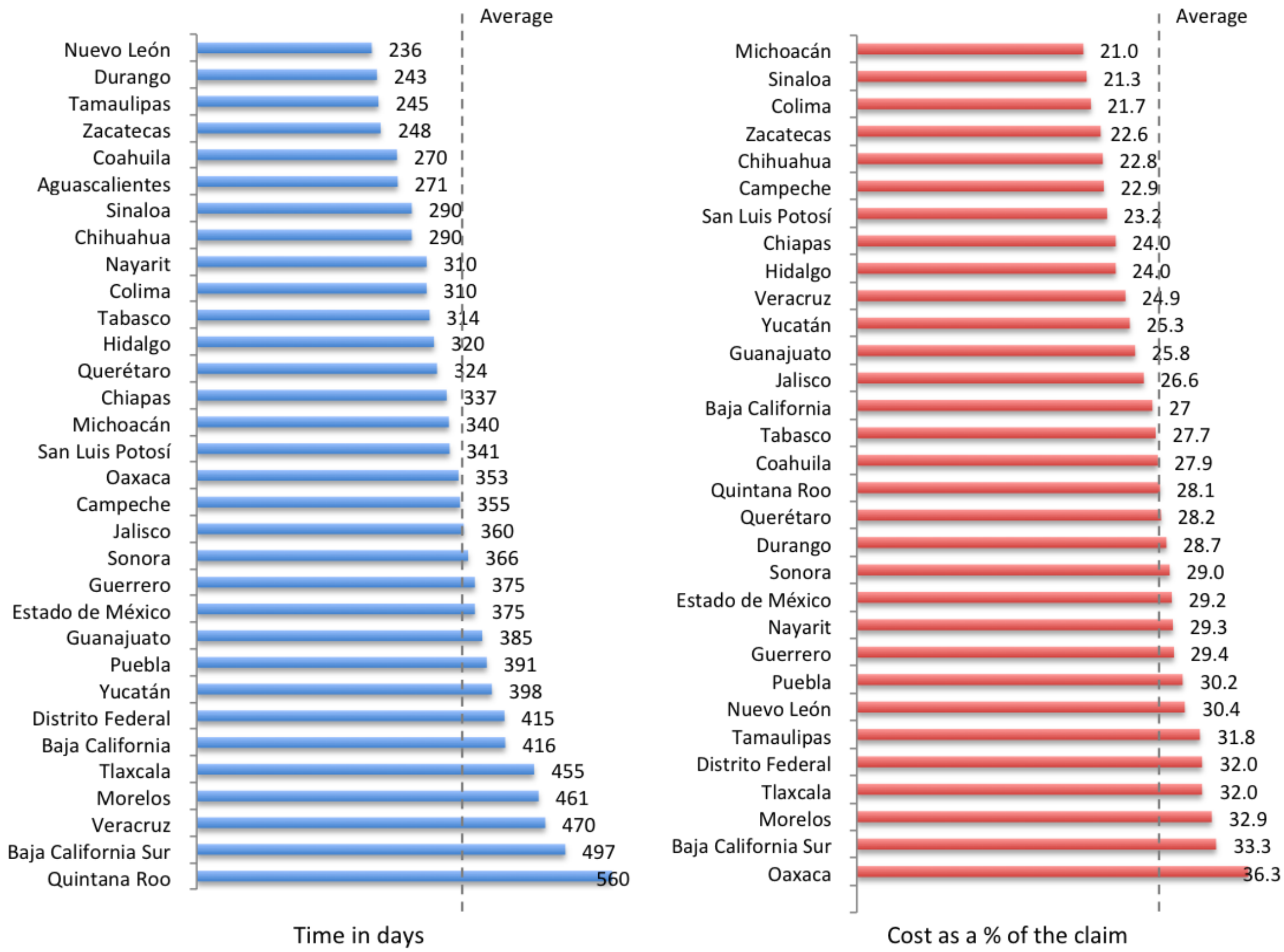

*Figure 20 – Resolving Insolvency (cost as % of the assets)*




Source: Doing Business 2013, Abt Associates analysis.

Some of the most important challenges related to commercial laws and regulations are at the state and local levels. Even though the number of procedures required to enforce a contract is about the same in all the Mexican states, the time and cost required to resolve a commercial dispute varies greatly (see Figure 21). While in Nuevo León it takes 236 days, the same case in Mexico City and in Morelos can take four to six months longer and more than twice that time in Quintana Roo. Nuevo León could be compared with the best performing countries in this procedure, like the Republic of Korea (236) or New Zealand (216), while a state like Quintana Roo could be compared to the worst performing countries, such as the Republic of Congo (560) or Yemen (569). Likewise, the cost of litigation goes from 20.6% of the claim value in Aguascalientes to 36.3% in Oaxaca (Doing Business, 2012).

*Figure 21 – Days and cost as a % of the claim for contract enforcement at subnational level*

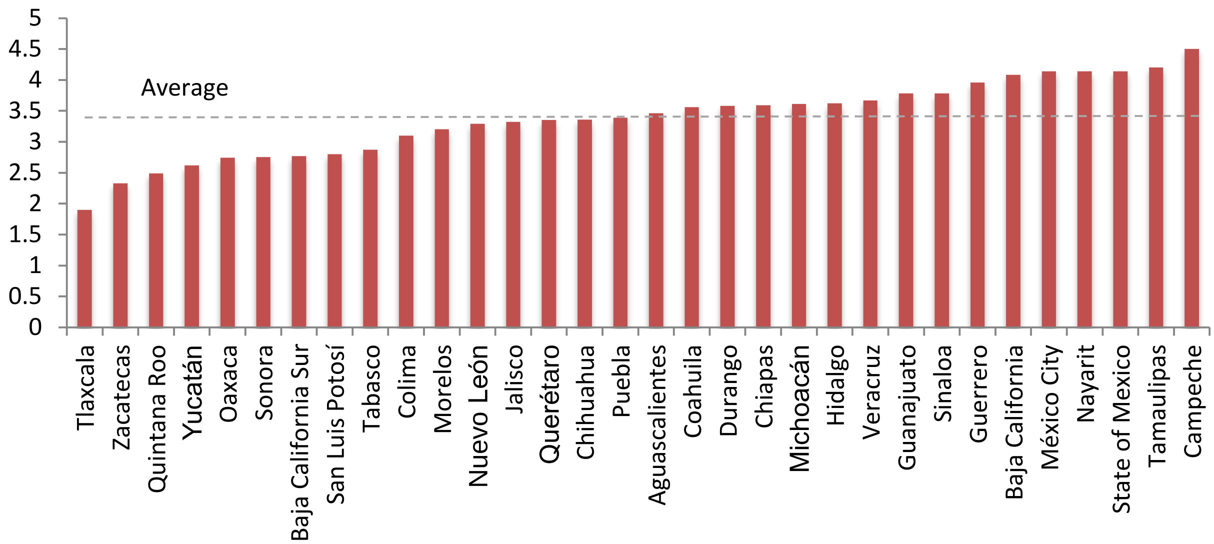



Source: Doing Business, 2012.

While the cost of red tape is important, rule of law is an even more serious problem. According to the Global Competitiveness Report 2012–2013 of the WEF, the most damaging factors undermining business activity are corruption, crime and theft. Again, states show significant variation. For example, according to the Consejo Coordinador Financiero (CCF) Duration of Commercial Procedures Index[15], there is wide disparity between Campeche, at 4.5, and Tlaxcala, the lowest ranking state with a 1.9 (see Figure 22).

[15] Index from 1 to 5, where a higher score is better.

*Figure 22 - Duration of Commercial Procedures Index*




Source: Consejo Coordinador Financiero, 2010.

## II. Which Institutions are responsible for improving economic performance?

Achieving significant improvements in Mexico's economic governance requires the commitment of key government stakeholders. MEPP selected the institutions it seeks to support based on their demonstrated willingness to confront the obstacles described above, as well as their capacity to implement change. This section does not provide a comprehensive review of all potential stakeholders. Rather, it identifies the most relevant government institutions whose goals can be advanced through foreign technical assistance, based on their commitment to carry out reforms or improve organizational practices.

**Office of the President (Presidencia) – Office of Digital Strategy**

Presidencia is a key actor in Mexican public policy initiative and design. One of the most important new priorities of Presidencia is promoting citizens' access to government information. The mandate to develop and implement the priorities of the President provides the new Office of Digital Strategy (ODS) with unique influence in setting the policy agenda on transparency and regulation within the information technology agenda. The ODS seeks to improve transparency across GOM institutions; make it easier for citizens, consumers, NGOs and firms to interact with government (e.g., obtain authorizations, make payments); and develop a legal framework governing access to and protection of electronic data. MEPP will work with Presidencia mainly in the project's Market Regulation policy area by streamlining business start-up procedures and assessing online business procedures. Although the main emphasis while working with Presidencia and ODS will be around the Market Regulation policy area, intrinsic to the activities is the promotion of transparency as shifting to an ICT-based government has the potential to reduce bureaucracy and enhance citizen participation.

**Ministry of Economy (SE)**

The Ministry of Economy is responsible for promoting high quality employment and economic growth through the design and implementation of public policies that increase competitiveness and productive investments. SE governs most of the country's funding for SME promotion, as well as foreign direct investment, international trade, and technical standards. SE therefore has a crucial cross-cutting role in shaping Mexico's economic policy. SE institutions include quasi-autonomous organizations such as the Federal Competition Commission, the National Entrepreneurship Institute and ProMexico, the country's principal export promotion agency.

Because SE works in so many economic governance areas, MEPP has been selective in proposing technical assistance, focusing on activities with the highest potential for achieving meaningful change in the areas of transparency, market regulation and access to finance. The Ministry has a mandate to design, promote and integrate public policies in innovation across different sectors of the economy. In this regard, MEPP will support SE's General Department of Technical Regulations and Standards to assess, verify and improve companies' compliance with technical standards. The misuse of Official Mexican Standards (NOMs) has serious repercussions to markets by creating entry barriers for new competitors and favoring monopolistic practices. MEPP can provide valuable assistance to enhance the institution's capacity in terms of its ability to design and carry out a more efficient standards compliance assessment. The objective is to increase the probability that standards are being complied with by businesses and thus, to prevent rent-seeking opportunities by some companies or interests groups.

In the area of Commercial Law, MEPP will carry out work that increases the transparency and reliability of business-to-business transactions. We will support the office of the Unique Guarantee Registry (RUG) to improve the design and operation of a system that validates non-real estates assets as viable collateral for commercial transactions.

**National Entrepreneurship Institute (Instituto Nacional del Emprendedor - INADEM)**
INADEM is a decentralized organization within the Ministry of Economy (SE). At the beginning of the Peña Nieto administration it was created to replace SE's Sub-Secretariat for Small and Medium-Size Enterprises, whose transparency and impact had been widely criticized in governmental and independent evaluations in previous years. INADEM was created in February of 2013, just a few months before MEPP began. Therefore, supporting INADEM creates a unique window of opportunity for USAID to contribute in the design of rules and criteria that ensure effectiveness and accountability for a major institution that interacts with thousands of SME beneficiaries. In particular, we will assist INADEM in developing a rigorous impact evaluation methodology, in order to determine the effectiveness of its programs. We will also identify best practices in the development Jalisco's technology cluster, in order to help INADEM create policies to replicate cluster promotion in other sectors and regions. Working with INADEM and IMPI, we will identify regulatory obstacles SMEs face in registering intellectual property to streamline the process of patent filing.

**National Council for Science and Technology (CONACYT)**
CONACYT is the public institution responsible for developing science and technology policies in Mexico. It has significant resources for promoting technology and innovation in the private sector. While CONACYT has been effective in selecting projects with strong potential, its selection criteria do not prioritize economic and commercial viability. MEPP will provide assistance to develop selection criteria that reward innovative firms with sound business plans and profit potential.

**Mexican Institute for Industrial Property (IMPI)**
The Mexican Institute of Industrial Property is a decentralized public body with legal authority to manage the intellectual property system in Mexico. The promotion of intellectual property can stimulate SMEs and high impact entrepreneurs. MEPP will work with IMPI to improve SMEs' competitiveness by proposing mechanisms to promote incentives and enhance capacity to create, register and protect intellectual property.

**Ministry of Finance (Secretaría de Hacienda y Crédito Público - SHCP)**

The Peña Nieto administration created a new Economic Productivity Unit (EPU) within SHCP. The unit reports directly to the Secretary and is responsible for ensuring that all GOM spending programs are aligned to principles of the President's "Democratization of Productivity" initiative. SHCP is widely recognized as the government's most influential economic governance organization, as it holds the purse strings that determine funding allocation decisions for almost all governmental programs and organizations. As such, SHCP has a unique capacity to promote accountability and change institutional practices across the public sector. The EPU requested technical assistance from MEPP to design a mechanism for transparently evaluating existing federal programs, assess their alignment with the "Democratizing Productivity" agenda, and, take measures to correct weaknesses.

**National Development Bank (Nacional Financiera - NAFIN)**

Nacional Financiera is Mexico's largest public development bank. It promotes saving and investment, and channels financial and technical support to industrial development and national and regional economic development in the country. To increase SME access to equity markets, NAFIN can help bridge the information gap between small enterprises and potential investors. Best practices related to corporate governance and financial presentation (balance sheets, income statements, among others) are essential for companies trying to access equity markets. NAFIN would ideally partner with INADEM to assist companies to improve the quality of corporate governance and financial management. In this context, MEPP will work with NAFIN to provide technical assistance to maximize the awareness and capacity of SMEs to solicit private investment.

**Mexico City Secretariat for Economic Development (SEDECO)**

The Secretariat for Economic Development is responsible for developing Mexico City's policy agenda. It also heads the mayor's economic cabinet. SEDECO is developing a strategy that includes detailed projects designed to spur growth among small business, promote the development of innovative sectors, and revitalize marginalized areas. It seeks to play a leading role in providing access to finance to improve productivity of innovative sectors and promote high impact entrepreneurs in Mexico City. MEPP will assist SEDECO in the creation of a new guarantee fund, leveraging NAFIN resources, that supports high impact entrepreneurs. Given the involvement of the national development bank and the visibility of the nation's capital city, the innovation promotion fund could be replicated in other large cities in the country.

**National Banking and Securities Commission (CNBV, Financial Regulator)**

The National Banking and Securities Commission is in charge of safeguarding the stability and integrity of Mexico's financial system. It regulates financial markets and promotes access to finance, two of MEPP's policy areas. In particular, we will work with CNBV to estimate the size of the cash-based economy and identify opportunities for regulatory reforms that promote non-cash transactions, which in turn would promote efficiency, reliability and security. We will also work with CNBV to reduce barriers to entry in the Mexican stock market and increase access to private equity markets.

**Ministry of Public Administration (SFP)**
***Digital Government Unit***
The Ministry of Public Administration has broad authority to create rules and procedures that all federal government institutions must follow. SFP designs and implements legal instruments and regulations that federal government agencies use to carry out procurement and payments for public works. While these processes have improved substantially at the federal level, there are still significant gaps at the state and local level. State government reform for the procurement of public works (construction and infrastructure) would increase transparency and competition while reducing corruption, resulting in significant cost savings. MEPP will also support SFP through an assessment of a pilot online business regulation initiative in the states of Jalisco and Colima, in collaboration with the Office of the Presidency. SFP seeks to develop and replicate consolidated business operation procedures to increase administrative efficiency, reduce burdensome and costly red tape, and eliminate opportunities for corruption. In addition MEPP will support SFP efforts to improve commercial law by creating specialized courts and simplifying the process for bankruptcy cases.

**Mexico City Judiciary (Tribunal Superior de Justicia del Distrito Federal)**
Local government legal proceedings are slow, expensive and unpredictable. The Tribunal is responsible for adjudicating decisions about contract enforcement between businesses, and between debtors and creditors. Mexico City has initiated a reform to institute the practice of oral trials, instead of written depositions. In order to reduce the time and expense of legal proceedings for contract enforcement, MEPP will work with Mexico City's Judiciary to implement oral trials.

**Federal Competition Commission (CFC)/Federal Economic Competition Commission (CFCE)**
The Federal Competition Commission is an independent agency of the Ministry of Economy, with technical and operational autonomy. CFC is responsible for investigating and curbing monopolies, anti-competitive practices and market concentration. It received enhanced authority to investigate and sanction firms under the amended Federal Law on Economic Competition. The President of the CFC and all of the commissioners will soon be replaced under a new appointment process led by the Senate, resulting in the new Federal Economic Competition Commission (CFCE). Changes in technical and administrative staff are expected. MEPP will maintain constructive dialogue with high-level technical staff who remain in the organization. An important area of opportunity, building on previous achievement of USAID technical assistance, is capacity building in information forensics. For example, MEPP would strengthen the ability of CFCE staff to extract and evaluate information obtained from computer files of companies under investigation, which could then be used as evidence to enforce CFCE rulings or in formal litigation.

**Bank of Mexico**

The Bank of Mexico is the country's central bank. It operates autonomously and is not subject to political interference from elected leaders. Its purpose is to issue currency, ensure macroeconomic stability and promote the development of the financial system. The Bank of Mexico plays an important role in Market Regulation. Over-reliance on cash transactions imposes costs on firms and families, as well as on the financial system. A transition to alternative means of payments could yield significant efficiency gains for the Mexican economy.

## III. What are we trying to achieve?

As described above, Transparency of Economic Governance Institutions, Market Regulation, SME Access to Finance and Commercial Law represent significant areas of opportunity to improve economic governance through strengthened policies and enhanced capacity of key Mexican institutions. However, to clearly convey what MEPP is trying to achieve – the tangible impact we seek to have on institutions that affect productivity and competitiveness – the Program can best be understood as the pursuit of six over-arching outcomes. This section describes each overarching outcome and illustrates their relationship to Mexico´s competitiveness environment outlined in the first section of this document.

**1. Government funds effectively promote private sector development and productivity**

In each activity under this objective, rules and regulations that govern public sector spending programs, especially those that promote business start-up, growth and innovation, will be created or modified to improve the transparency and effectiveness of government investments. Governance changes will focus on criteria for selecting beneficiaries and rigorous program performance evaluation methodology.

For instance, to achieve greater budget transparency and reduce corruption, MEPP will evaluate existing federal government subsidy programs, health sector public procurement, programs designed to stimulate the growth of SME's and a technology promotion program. To address the problem of lack of access to proper finance mechanisms, MEPP seeks to improve the selection criteria of an existing program whose goal is to promote innovation. In an effort to promote access to finance -especially to high impact entrepreneurs- MEPP will design a local government funding mechanism that expands finance options for firms that demonstrate significant potential in promoting innovation or employment. Furthermore, to promote public policies that catalyze Mexico's innovative potential, MEPP will carry out a case study of Jalisco's technology cluster and formulate proposals for government support that can be replicated in other sectors and regions.

**2. Businesses face fewer obstacles to growth**

Activities under this objective will result in specific proposals to make regulations affecting business start-up and operation more transparent and less costly. Regulatory change will occur at any of or all three levels of government (national, state, municipal).

The burden of regulation is a major obstacle to market competition and entrepreneurship in Mexico. MEPP will contribute to the streamlining of start-up procedures to reduce barriers to entry by measuring the impact of an existing pilot project in Jalisco and Colima that makes available business procedures online. Based on the evaluation findings, best practices from this pilot will be applied to cover other states of the country. Businesses face many limitations ranging from misuse of norm setting processes to lack of protection of property rights, thus

MEPP will take on the task of identifying obstacles to high impact and municipal entrepreneurship to increase transparency at the subnational level and to promote market regulation

**3. Competition is improved**

As identified previously, the existence of monopolies in key public and private sectors limit Mexico's competitive potential. Small businesses face high fixed costs and, as mentioned above, the burden of regulation creates additional costs which can inhibit market entrance. In an effort to increase market competition and improve consumer welfare, MEPP will strengthen regulations and institutional capacity to ensure effective enforcement of the country´s recently amended competition law. The Program will also seek to reduce barriers to entry for new competitors, especially in markets subject to high concentration or collusion. More specifically, MEPP will work to improve the compliance assessment for technical regulations and standards, reform state government procurement of public works and promote intellectual property. In addition, to improve the capacity of the Federal Competition Commission (CFC) to enforce Mexico's recently amended competition law, MEPP will help the Commission strengthen of its information forensic capabilities. Information forensics is critical for the analysis and presentation of evidence obtained from companies under investigation for anti-competitive practices. Finally, MEPP will organize a major forum to present international experiences in developing legal frameworks that govern digital transactions, in order to reduce barriers to e-commerce.

**4. Regulatory reform improves SME access to private capital**

A very low proportion of Mexican SMEs have access to private capital markets (compared to those in countries with similar levels of development). The lack of equity finance, in turn, limits the potential of smaller firms to grow or even start up. MEPP will work to reduce barriers to entry to the Mexican stock market so as to increase sources of financing and investment opportunities for a greater number of enterprises. MEPP will also work with NAFIN, the country's main development bank, to improve the effectiveness of public sector incentives for private investment in promising SMEs.

**5. Business transactions are more efficient and reliable**

Because entrepreneurs across Mexico face different regulations and local practices depending on the state and city in which they do business, MEPP will focus on making business transactions more efficient and reliable at the national and subnational level. Activities that promote this outcome will result in modification of regulations and judicial processes that impose costs on businesses that seek to carry out a higher volume of economic transactions, as well as those seeking to resolve claims and disputes with other firms or organizations. The reforms will increase the transparency and reliability of relevant government institutions, while reducing the time and expenditure required to carry out business transactions. This objective will be pursued mainly in collaboration with the Ministry of Economy, Ministry of Public Administration and selected state governments.

**6. Citizens have greater access to public information and participate in public policy design**

To improve governance across all policy areas, MEPP will seek to improve accountability and transparency in Mexico through democratic crowdsourcing models. A crowdsourcing model will be designed to finance the development, implementation and maintenance of applications selected by competition to enhance the interaction between society and the government entities outlined above. Governmental and non-governmental organizations will launch mobile applications that increase the quality and quantity of governmental information available to the public, or that make it easier for individuals, civil society groups and businesses to interact with government agencies and programs productively.

## IV. What is the level of commitment?

Political commitment to reform is essential for the success of any economic governance assistance initiative. As discussed earlier, evidence of commitment includes: dedication of an organization's own resources and personnel to carry out USAID-supported activities, public declarations of commitment by political leaders (such as inclusion within the National Development Plan 2013 – 2018), and regular participation of high level officials. In the table below, as an initial measure of commitment, we map MEPP objectives to those of the National Development Plan (PND).

| | | MEPP´s Overarching Objectives | | | | | |
|---|---|---|---|---|---|---|---|
| PND Objective | Strategy* | Government funds effectively promote private sector development and productivity | Business' face fewer obstacles and have access to resources that facilitate growth | Competition is improved | Regulatory reform improves SMEs access to private capital | Businesses transactions are more efficient and reliable | Citizens have greater access to public information and participate in public policy design |
| **4.1. Maintain macroeconomic stability** | 4.1.3 | X | | X | | | |
| **4.2. Democratize access to finance projects with growth potential** | 4.2.1 | | | | | X | |
| | 4.2.2 | | | | X | | |
| | 4.2.4 | X | | | | | |
| | 4.2.5 | | | X | | | |
| **4.5. Democratize access to telecommunication services** | 4.5.1 | | | | | | X |
| **4.7. Guarantee rule clarity to incentive the development of a competitive internal market** | 4.7.1 | X | X | X | X | | |
| | 4.7.2 | | X | | | X | |
| | 4.7.3 | | | X | | | |
| | 4.7.4 | X | | X | X | X | |
| **4.8. Develop the country's strategic sectors** | 4.8.1 | X | | | | | |
| | 4.8.3 | X | | | | | |
| | 4.8.4 | X | | X | | | X |

*Strategy Key

4.1.3. Promote efficient allocation of available budget resources and use savings to strengthen priority programs in agencies and states;

4.2.1. Broaden financial system coverage to include parts of the population that are currently excluded;

4.2.4. Increase access to credit and other financial services to economic actors in strategic sectors that face access difficulties; with special emphasis on priority areas for national development and patent creation;

4.2.5. Promote the private sector's participation in the development of infrastructure, structuring state and local government participation to promote high social impact projects that increase infrastructure coverage and quality;

4.5.1. Promote telecommunications development and innovation by broadening coverage and access to foster better services and promote competition, seeking cost reductions and efficiency;

4.7.1. Enhance competition in the domestic market;

4.7.2. Implement a comprehensive regulatory strategy;

4.7.3. Strengthen the norm setting process and its compliance evaluation system;

4.7.4. Promote higher investment levels through sensible regulations and efficient promotion;

4.8.1. Develop economic promotion policies aimed at increasing productivity in dynamic and traditional sectors regionally, keeping sectorial balance;

4.8.3. Guide and make public spending more efficient to strengthen the internal market;

4.8.4. Foster entrepreneurship and strengthen SMEs.

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